

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: SR&T Committee Analyst: LuAnna Hass Bill Number: SB 1185

Related Bills: See Legislative History Telephone: 845-7478 Amended Date: April 19, 2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Change B&CT Law to Corp. Tax Law/Elec. Postmarks/MIC Recapture Exception/RAR Refund Statute/Expand Voluntary Disclosure Program To Trusts

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

☒ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced February 28, 2001.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 28, 2001, STILL APPLIES.

OTHER - See comments below.

SUMMARY

This Franchise Tax Board (FTB) sponsored bill would:

- rename the "Bank and Corporation Tax Law" as the "Corporation Tax Law,"
- make California law substantially the same as the federal law that permits electronic postmarks to be proof of the date an e-file return is filed,
- add multi-jurisdictional trusts as participants in the FTB voluntary disclosure program,
- allow FTB to initiate action on taxpayer accounts that are overpaid, and
- specify that taxpayers taking the federal election to treat a stock purchase as an asset purchase would not trigger a recapture of the Manufacturers' Investment Credit.

SUMMARY OF AMENDMENTS

The April 19, 2001, amendments removed the bill's provisions that related to amending the definition of "qualified employee" for specified economic development areas and clarifying the vouchering requirements, and replaced them with the provisions discussed in this analysis. The amendments would:

- allow qualified trusts to participate in the voluntary disclosure program,
- define "qualified trust" and "qualified beneficiary" for purposes of the voluntary disclosure program,
- replace the term "qualified business entity" with "qualified entity" and substitute the specific law for the phrase "the act adding this subdivision" within the existing laws regarding the voluntary disclosure program,

Board Position:

<input checked="" type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

05/25/01

- allow FTB to make a refund, allow a credit, or mail a notice of proposed overpayment to taxpayers.
- specify that taxpayers making (or deemed to have made) the federal election to treat a stock purchase as an asset purchase would not trigger a recapture of the Manufacturers' Investment Credit.
- specify the date of final Treasury Regulations for purposes of electronic postmarks.

The provisions of this bill will be discussed separately.

Except for the discussion of the provision relating to economic development areas, the remainder of the department's analysis of the bill as introduced February 28, 2001, still applies. The following technical considerations still apply and are included below for convenience.

BANK AND CORPORATION TAX LAW CHANGES

TECHNICAL CONSIDERATIONS

Amendments 4 and 6 are provided to rename Part 11 of Division 2 (and Chapter 2 of the same division) of the Revenue and Taxation Code (R&TC). Amendments 5 and 8 are provided to renumber the sections of the bill.

ELECTRONIC POSTMARKS

TECHNICAL CONSIDERATIONS

For consistency within the R&TC, Amendments 2 and 3 are provided to include an additional cross-reference.

EXPAND VOLUNTARY DISCLOSURE PROGRAM TO TRUSTS

PURPOSE OF THE BILL

The purpose of this bill is to encourage multi-jurisdictional trusts to voluntarily comply with California income tax laws.

EFFECTIVE/OPERATIVE DATE

These provisions would be effective January 1, 2002, and apply to voluntary disclosure agreements entered into on or after January 1, 2002.

POSITION

Support.

At its December 18, 2000, meeting, FTB voted 2-0 to sponsor the language introduced in this legislation.

Summary of Suggested Amendments

The attached amendments would resolve the department's technical concern discussed below.

ANALYSIS

FEDERAL/STATE LAW

Voluntary Disclosure Program

A review of federal tax laws is not relevant to the provisions of this bill relating to voluntary disclosure program for business taxpayers, as federal law does not provide a voluntary disclosure program for these taxpayers.

Under state law, FTB is authorized to enter into voluntary disclosure agreements with (1) qualified business entities and (2) qualified S corporation shareholders that, in good faith, have failed to comply with California's registration, reporting and payment requirements. A "qualifying business entity" includes any out-of-state bank or nonexempt corporation that has never filed a California income tax return and voluntarily comes forward prior to any contact from FTB regarding income tax liability. A "qualified shareholder" is a nonresident shareholder of an S corporation that has applied for a voluntary disclosure agreement and disclosed all material facts pertaining to the shareholder's liability.

Under the terms of the agreement, FTB waives penalties for noncompliance with specified reporting and payment requirements for the six taxable years immediately preceding FTB's signing of the agreement. For taxable years ending more than six years prior to the agreement, the business's income or franchise taxes, additions to tax, fees, or penalties also are waived. The Franchise Tax Board must approve all voluntary disclosure agreements.

Taxation of Trusts

Under federal law, trusts are generally treated as separate taxpayers and are taxed in the same way as an individual to the extent income is retained by the trust. Where trust income is retained by the trust, that income is taxed to the trust at specified trust rates.

However, trust income is not normally retained by the trust, but is distributed to the trust beneficiaries. The income retains the same character and tax attributes in the hands of the beneficiary as in the hands of the trust.

State law generally conforms to the federal law governing the taxation of trusts. Exceptions to the federal provisions applicable to trusts are Personal Income Tax Law (PITL) provisions that do not conform to federal law and provisions on residency.

All income of the trust derived from California sources and not distributable is taxable to the trust irrespective of the residence of the trustees or the beneficiaries. The taxability of non-California source income retained by a trust and allocated to principal depends on the residence of the trustees and noncontingent beneficiaries, not the residence of the person who established the trust.

The entire income of a trust is subject to tax by California if either all the trustees or all the beneficiaries are residents. Contingent beneficiaries are not considered for purposes of determining taxability of a trust. The residence of a corporate trustee is the place the corporation transacts the major portion of its administration of the trust.

State law outlines specific rules for the taxability of the trust depending on the combination of resident and nonresident trustees, as well as contingent and non-contingent beneficiaries.

Taxation of Nonresident Income

California law imposes a tax on all income of residents of California regardless of source. A tax is imposed on the income of nonresidents to the extent that it is derived from or attributable to sources within this state. "Income from sources within this state" is defined by regulation as income from tangible or intangible property located or having a situs in this state and income from any activity carried on in this state, regardless of whether carried on in intrastate, interstate, or foreign commerce. The law provides six personal income tax rate brackets ranging from 1% to 9.3%.

THIS BILL

This bill would allow qualified trusts to participate in the voluntary disclosure program. This bill would define "qualified trust" and "qualified beneficiary" for purposes of the voluntary disclosure program.

This bill would replace the term "qualified business entity" with "qualified entity." This bill also would substitute the specific law for the phrase "the act adding this subdivision."

IMPLEMENTATION CONSIDERATIONS

This bill would be implemented within FTB's existing Voluntary Disclosure Program and would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

Amendment 1 would insert a missing word.

LEGISLATIVE HISTORY

AB 2880 (Stats. 1994, Ch. 367), a Franchise Tax Board sponsored bill, established a California Voluntary Disclosure Program. SB 38 (Stats. 1996, Ch. 954) added S corporation shareholders to California's Voluntary Disclosure Program.

PROGRAM BACKGROUND

Nexus is a constitutional requirement that must be satisfied before any state can exercise its power to tax. Nexus is a level of presence or activity within the state that creates a connection between the state and the business or individual so that it is fair for the state to impose a tax.

AB 2880 (Stats. 1994, Ch. 367), a Franchise Tax Board sponsored bill, established a California Voluntary Disclosure Program. Under this program, certain out-of-state banks and corporations can voluntarily disclose their California presence or activities, and FTB may waive its authority to assess or propose to assess taxes, additions to tax, fees or penalties with respect to years ending six years before the signing of the disclosure agreement.

SB 38 (Stats. 1996, Ch. 954) added S corporation shareholders to California's Voluntary Disclosure Program. To limit the concern that applying the waiver authority to S corporation shareholders could be viewed as amnesty for these individuals, participation in the California Voluntary Disclosure Program was limited to those S corporation shareholders who are nonresidents for the year that the agreement is signed.

FTB staff regularly receives inquiries from representatives of trusts, partnerships, and limited liability companies that wish to enter the voluntary disclosure program. They offer to have their clients come forward and file returns in California and pay several years tax and interest. Without exception, the department is compelled to decline these offers because the voluntary disclosure program is limited by statute to corporations and non-resident S corporation shareholders.

OTHER STATES' INFORMATION

A review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found that each state has a voluntary disclosure program. *Michigan's* program specifically includes trusts. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

The Multistate Tax Commission has a National Nexus Program that allows businesses to voluntarily resolve potential state sales and use or income and franchise tax liabilities. The program acts as a coordinator that allows businesses to approach several of the 40 participating states anonymously and seek resolution. Of the states listed above, *Illinois* and *New York* do not appear to offer either voluntary disclosure program.

FISCAL IMPACT

These provisions would not impact the department's costs.

ECONOMIC IMPACT

Revenue Discussion

It is projected that this bill would generate revenue gains on the order of \$1 million annually. The number of multi-jurisdictional trusts and qualified beneficiaries that come forward and voluntarily enter into a disclosure agreement and the amount of taxes paid by primarily corporate trustees would determine the revenue impact of this bill.

Although departmental staff has received inquiries from representatives of multi-jurisdictional trusts about entering the tax system, the department is compelled to decline any offers because of statutory restrictions. The volume of voluntary disclosure agreements for trusts and the amount of tax revenue generated is expected to be less than that of corporations under the current program. Under the current program, it is estimated that about 20 applications are received each year from corporations resulting in revenue collections of approximately \$2 million annually.

REVENUE AGENT REPORT REFUND STATUTE

PURPOSE OF THE BILL

The purpose of this bill is to allow FTB the authority to initiate action on overpaid amounts.

EFFECTIVE/OPERATIVE DATE

These provisions would be effective January 1, 2002, and operative for federal determinations that become final on or after January 1, 2002.

POSITION

Support.

At its December 18, 2000, meeting, FTB voted 2-0 to sponsor the language introduced in this legislation.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, a claim for credit or refund of a tax paid by return must be filed within three years from the date the return was filed or two years from the date the tax was paid, whichever occurs later. If the required return was not filed, the claim must be filed within two years from when the tax was paid. Federal law outlines specific exceptions when a longer refund claim period exists. These exceptions have varied claim period limits and include situations where an overpayment results from a bad debt or worthless securities, payment of foreign taxes for which a foreign tax credit is allowed, or from carryback of an NOL, net capital loss, or business credit.

Generally, state law outlines statutes of limitation (SOL) that set forth the period both for FTB to issue a notice of proposed (deficiency) assessment (NPA) and for taxpayers to claim refunds or credits of overpaid amounts (hereafter "overpayments"). The general SOL for FTB to issue an NPA is four years after the date the tax return is filed. The general SOL for a taxpayer to claim an overpayment is the later of four years from the original due date of the tax return, four years from the date of filing a timely return, or one year from the date of payment that resulted in the overpayment. These general SOLs may be extended if the taxpayer executes a waiver or automatically if an IRS audit is in progress.

A taxpayer is generally required to notify FTB of a Final Federal Determination (FFD) that results in a California tax deficiency. However, whether or not the taxpayer makes a timely notification, FTB is expressly authorized to initiate action by NPA on the tax deficiency as a result of the FFD. State law is silent on whether FTB can initiate action on an overpayment.

THIS BILL

This bill would allow FTB to make a refund, allow a credit, or mail a notice of proposed overpayment to taxpayers. The refund, credit, or notice must be within two years of the final determination date that reported IRS changes or within the existing SOL time period.

IMPLEMENTATION CONSIDERATIONS

This bill would give FTB express authority to initiate action on overpayments resulting from an FFD and would clearly allow for such overpayments to be processed by FTB staff. Implementing this bill would occur during the department's normal annual update.

PROGRAM BACKGROUND

Through an exchange of information agreement with the IRS, FTB receives Revenue Agent Reports (RARs) that show changes resulting from IRS audits of California taxpayers. An RAR that reports final IRS changes is called an FFD and may show the following federal income tax changes:

1. a deficiency assessment for a given year;
2. an over-assessment for a given year; or
3. both a deficiency assessment for one year or several years and an over-assessment for other years.

FFDs are important for state tax purposes because an adjustment in federal tax will generally result in a similar adjustment in California tax.

OTHER STATES' INFORMATION

A review of *Illinois*, *Massachusetts*, *Michigan*, and *New York* laws found that *Michigan*, *Illinois*, and *New York* allow overpayments on state income tax as a result of federal adjustments to be refunded, although the taxpayer must affirmatively file a claim for the overpayment amount. The Commissioner of Revenue in *Massachusetts* may deduct the amount of a state income tax overpayment from any other taxes due from the taxpayer. *Massachusetts* does not specifically address overpayments as a result of a federal adjustment. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This bill should not increase FTB's departmental costs. Staff anticipates that any additional costs that may be attributable to this bill would be absorbed by the efficiencies realized from not having the refund claim filed and processed.

ECONOMIC IMPACT

Revenue Discussion

The potential impact is indeterminable but considered minor, less than \$500,000 annually.

MANUFACTURERS' INVESTMENT CREDIT (MIC) RECAPTURE EXCEPTION

PURPOSE OF THE BILL

The purpose of this bill is to ensure the sale of stock for which the federal election has been made or was deemed made would not trigger the recapture of the MIC.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2002, and operative for taxable years beginning on or after January 1, 2002.

POSITION

Support.

At its December 18, 2000, meeting, FTB voted 2-0 to sponsor the language introduced in this legislation.

Summary of Suggested Amendments

The attached amendments would resolve the department's implementation concern discussed below.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business and allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or for investment property.

Existing federal law does not have a credit comparable to the MIC.

Existing state law allows qualified taxpayers a credit, known as the MIC, equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification Manual. Qualified property is any of the following:

- 1) Tangible personal property as specified in federal tax law and used for specific purposes.
- 2) Special purpose buildings and foundations that are an integral part of specified activities.
- 3) The value of any capitalized labor costs directly allocable to the construction or modification of tangible personal property or for special purpose buildings and foundations.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, such as equipment used in an extraction process.

The taxpayer must recapture any MIC previously allowed if, among other reasons, the property is disposed of to an unrelated party within one year from the date the property is first placed in service in California.

Treatment Of A Stock Purchase As An Asset Purchase

Both federal and California law allow or require certain stock purchases to be treated as asset acquisitions. A purchasing corporation can make an irrevocable election to treat the purchase of stock of another corporation (the target corporation) as an asset purchase. The target corporation is treated as having sold all of its assets at the close of the acquisition date at fair market value and is treated as a new corporation that purchases all of the assets the beginning of the day after the acquisition date.

A “purchasing corporation” means any corporation that makes a qualified purchase of stock from another corporation.

A “target corporation” means any corporation whose stock is acquired by another corporation in a qualified stock purchase.

Specific Treasury Regulations (Section 1.338-1T(b)(1)) provide that the target corporation must be treated as a new corporation that is unrelated to the old corporation for income tax purposes. For other than income tax purposes, the target corporation is treated as a continuation of the old corporation.

Federal law allows the seller and target corporation to elect jointly to include the gain from the deemed sale of the target corporation's assets in the consolidated return of the seller and to allow the seller not to report the gain on the sale of stock. The target corporation is deemed to have sold all of its assets while the target corporation is still owned by the seller. The target corporation is deemed to distribute all of its assets in complete liquidation, and the seller does not recognize the gain on the sale of stock.

California sales tax regulations state that the sale of stock of a corporation is not a sale of tangible personal property and is not subject to sales tax despite the federal income tax treatment described above. This treatment for sales tax purposes is consistent with the federal regulations that provide that the election applies only for purposes of income tax provisions.

THIS BILL

This bill would specify that taxpayers making (or deemed to have made) the federal election to treat a stock purchase as an asset purchase would not treat the sale of the stock as a disposition of qualified property for purposes of the MIC.

IMPLEMENTATION CONSIDERATIONS

For purposes of the MIC, this bill would state that the sale of stock “may” not be treated as a disposition of qualified property. The use of the phrase “may” gives the appearance that an option exists and that the stock could be treated as a disposition of qualified property. This could lead to confusion with taxpayers, as the language doesn’t address when the taxpayer may take either option. Amendment 7 is provided to replace the word “may” with “shall.”

If this bill were amended to resolve this concern, implementing this bill would not significantly impact the department.

OTHER STATES’ INFORMATION

A review of *New York*, *Illinois*, *Massachusetts* and *Michigan* tax laws found investment tax credits that are similar to the MIC. *New York* tax law provides that neither the merger of a *New York* corporation into another corporation nor a corporate spin-off that is a tax-free reorganization causes recapture of the investment tax credit. No information was provided regarding the federal election to treat a stock purchase as an asset purchase for *Illinois*, *Massachusetts*, or *Michigan*. It could not be determined if the issue of recapturing the MIC in this instance occurs for these states.

FISCAL IMPACT

This bill would not significantly impact the department’s costs.

ECONOMIC IMPACT

Revenue Discussion

Based on limited data and discussions with FTB’s Legal staff, it is not anticipated that this bill would have a significant revenue impact. Preparations are usually made by the taxpayer well in advance (on average approximately six to eight months) of the sale of stock for which an election is made (or is deemed to have been made) pursuant to federal law (to which California conforms). Relatively few taxpayers are subject to the current MIC recapture provision.

LEGISLATIVE STAFF CONTACT

LuAnna Hass
Franchise Tax Board
845-7478

Brian Putler
Franchise Tax Board
845-6333

Analyst	LuAnna Hass
Telephone #	845-7478
Attorney	Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1185
As Amended April 19, 2001

AMENDMENT 1

On page 35, line 13, after "An" insert:

entity

AMENDMENT 2

On page 41, modify line 8 as follows:

Section 17001), Part 10.2 (commencing with Section 18401), Part 11 (commencing with Section 23001), or this

AMENDMENT 3

On page 41, modify line 11 as follows:

(commencing with Section 17001), Part 10.2 (commencing with Section 18401), Part 11 (commencing with

AMENDMENT 4

On page 41, line 36 after "SEC. 12." insert:

Part 11 of Division 2 of the Revenue and Taxation Code is amended to be entitled:
"Corporation Tax Law"

Sec. 13.

AMENDMENT 5

On page 42, line 1, strikeout "SEC. 13." and insert:

SEC. 14.

AMENDMENT 6

On page 42, line 11, insert:

SEC. 15. Chapter 2 of Part 11 of Division 2 of the Revenue and Taxation Code to be entitled:

"The Corporation Franchise Tax"

AMENDMENT 7

On page 70, line 10, strikeout "SEC. 14." and insert:

SEC. 16

AMENDMENT 8

On page 81, line 3, strikeout "may" and insert:

shall

AMENDMENT 9

On page 81, line 33, strikeout "SEC. 15.," and insert:

SEC. 17.